BOFIT Forecast for Russia
14.2.2008

BOFIT Russia Desk

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SUOMEN PANKKI FINLANDS BANK
EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland
BOFIT – Institute for Economies in Transition

Bank of Finland
BOFIT – Institute for Economies in Transition

PO Box 160
FI-00101 Helsinki
Phone: +358 10 831 2268
Fax: +358 10 831 2294
bofit@bof.fi

www.bof.fi/bofit

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In light of last year's faster-than-expected growth of the Russian economy, BOFIT's growth forecast has been revised upward. The forecast for 2008–2010 puts this year's growth rate at nearly 8%, easing to 6% per annum by the end of the forecast period. The outlook for rapid growth is bolstered by a projected oil price (Urals grade) in the range of USD 80 to USD 90 per barrel. While brisk consumption growth remains the basis of Russia's economic growth, booming investment has recently taken on a greater importance. Because Russia's imports are predicted to continue to expand faster than exports, the current account surplus could disappear by 2011.

The Russian economy remains highly dependent on the extraction of natural resources. Some two-thirds of export income and half of central government budget income derive from oil and natural gas, which makes Russia quite dependent on developments in the world price of oil. The forecast assumes that the price of oil will track price movements in the futures market and decline to about USD 80 by 2010.

Russia's rapid economic growth has been supported by an upward trend in oil prices due to briskly expanding consumption and, more recently, investment. Last year private consumption grew 13%, bolstered by a 16% increase in average real wages. Because the consumption is partly debt-financed, borrowing by private individuals has increased substantially. The forecast sees a deceleration of private consumption expenditure - as wage growth slows - to about 10% per annum by the end of the forecast period.

The rate of rise in investment climbed to 21% last year, as did the investment-to-GDP ratio. The investment growth seems to be spread rather evenly across the various sectors of the economy. The Russian economy continues to require sizeable investments for purposes of diversification and post-Soviet modernisation of infrastructure. Investment growth is expected to continue at a brisk pace, albeit slowing to about 15% pa by the end of the forecast period.

Russia has been able to respond to the rapid growth in consumption and investment partly by increasing domestic output; the growth rate of industrial production rose to just over 6% last year. Processing industry grew 9% in 2007, led by machine and equipment manufacturing. On the other hand, the extractive sector continues to post considerably slower growth than the other production sectors. Oil production increased 2% while natural gas output declined slightly. The growth of consumption demand is also visible in the service sector; last year construction growth accelerated to 18%. The retail sector also posted faster growth - 15% - albeit the sector depends heavily on imports.

Rapid import growth is reducing the current account surplus

Domestic output alone has not been sufficient to satisfy robustly growing consumption and investment demand; imports have increased sharply in recent years. In fact, real imports jumped 30% last year, abetted by higher income and real appreciation of the rouble. Although import growth is expected to remain robust, it is projected to slow to about 15% pa by the end of the forecast period, as both income and the real external value of the rouble decelerate.

Russia's export growth depends largely on energy products. Export volume has increased at an annual rate of about 7% in recent years. Boosting oil production and exports in the coming years will require still more investments. But heavy taxation of oil revenues and an uncertain business climate, among other things, have discouraged companies from investing heavily in the energy sector. Export growth is predicted to moderate slightly during the forecast period.

With imports growing notably faster than exports, Russia's current account surplus has begun to shrink. The surplus in fact exceeded 11% of GDP in 2005 but declined to 6% last year. The weakening of the US dollar vs the euro may also negatively impact the surplus, since Russia's export earnings are predominately in dollars while most imports are paid for in euro. Under the assumed price path for oil and growth rate for imports, the current account surplus will dissipate by 2011, albeit exchange rate reactions could affect the outcome.

In contrast, the financial account has moved into surplus. Capital flows into Russia have expanded, especially in the form of loans but also as investments. At the start of October 2007, Russia's external debt amounted to 37% of GDP. Companies and banks are doing most of the borrowing, whereas the public sector has rapidly reduced its debt level.

The international liquidity crunch in the latter part of last summer has not notably impacted the overall performance of the Russian economy. It did cause problems especially for some small banks that, due to low creditworthiness, have had trouble obtaining finance from the domestic interbank market. Uncertainty in the international financial markets has been reflected also in a dampening of stock market developments. Prolongation of the uncertainty could slow the stream of foreign capital into Russia.

Challenges for economic policy – inflation and public sector spending

Despite the narrowing of the foreign trade surplus rapidly growing capital inflows have maintained upward pressure on inflation and on the rouble's external value. The broad money supply (M2) increased last year by nearly 50% and annual inflation rose to 11.9% - clearly higher than the 8% target of the Government and central bank. The pronounced pick-up in inflation last year was also partly due to a rapid rise in food prices. In order to curb food price inflation, the Government has exceptionally resorted to price controls and export tariffs.

Noteworthy in terms of competitiveness is that the rouble's real effective (trade-weighted) exchange rate rose by 5.3% last year. For the time being, the central bank's top priority has been to stabilise the rouble's nominal exchange rate, even at the cost of higher inflation. With export revenues and capital inflows remaining at high levels, it is expected that upward pressure on the rouble will continue in the coming years. However, the strengthening of the rouble is expected to moderate towards the end of the forecast period as the price of oil declines and the current account surplus shrinks.

Russian fiscal policy has been relatively tight since the turn of the millennium. The federal budget has been in large surplus due to abundant oil revenues. The federal government's finances are on a very sound footing, as oil revenues have been accumulated in the stability fund and used for early pay-down of foreign debt. Russia's stability fund amounted to 12% of GDP at the start of the year, compared to federal government foreign debt of only 3% of GDP. As oil revenues have accumulated so too has the pressure to boost federal spending. In 2007 the growth rate of central government consumption expenditure rose to nearly 5%. Russia has now adopted a 3-year budget frame. The aim for the first 3-year period, 2008 – 2010, is to keep federal budget expenditures around 18-19% of GDP. The planned increase in federal government spending for the current 3-year period would support the robust growth of consumption and investment.

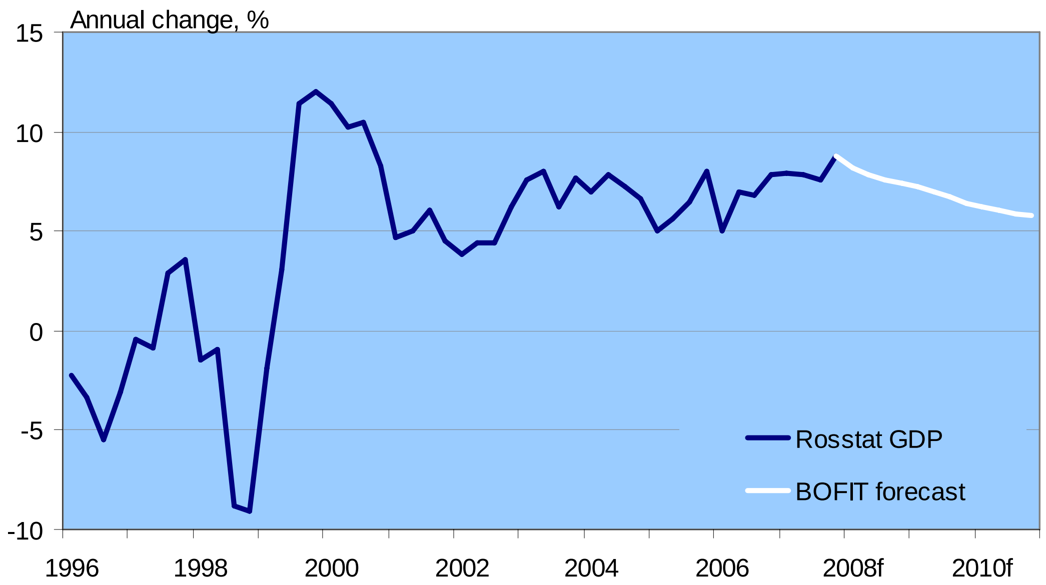
Risks relate primarily to the price of oil

Since Russia's economic growth has been largely due to continually rising oil prices the major risk for continued robust growth is the possibility of a notable decline in the price. However, the effects could be muted somewhat with the aid of macroeconomic buffers and by an increase in public spending. The presidential election set for March is not expected to bring any significant change to the overall stance of economic policy. Restraining inflation will remain a key objective of economic policy in the current year.

If the price of oil remains at a high level, the current account will remain in surplus over the next few years, but by the end of the forecast period it should be roughly in balance. If the surplus completely disappears, the rouble could weaken and borrowing from abroad increase further. The ongoing rise in foreign debt may pose a challenge to the financing of future investment, especially if the uncertainty in the international financial markets continues. Although private sector borrowing from abroad has increased substantially indebtedness so far remains at a moderate level.

Over the forecast horizon, Russia's economic performance looks very good. But peering further ahead one sees a number of challenges for maintaining the robust growth rate. These include the need to diversify the structure of production and to attract large investments in almost every sector of the economy. If the recent rapid growth of investment continues, the possibilities for meeting these challenges will improve. Another factor that might gradually dampen economic growth is a worsening shortage of skilled labour.

Yearly changes in Russian GDP, 1996–2010



Sources: Rosstat 1996–2007, BOFIT forecast 2008-2010

Real changes in GDP and imports, 2006–2010

	2006	2007	2008[f]	2009[f]	2010[f]
GDP	7.4	8.1	7.6	6.8	6.0
Imports	21.6	30.4	25.0	20.0	15.5

Sources: Rosstat 2006–2007, BOFIT forecast 2008-2010